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International Economic & Energy Weekly

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18 April 1986

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18 April 1986

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International Economic & Energy Weekly 25X1

Synopsis

1 **Perspective—Internationalization of World Industry** 25X1

Over the past several decades, corporations—both US and foreign—have found it increasingly necessary to form alliances with foreign firms in order to remain competitive. To the extent extraterritorial groupings operate outside the framework of international trade agreements, such as GATT, the United States will in the future be more concerned with corporate than government trade policies. 25X1

3 **Summit Issues: EC-Japanese Trade Tensions** 25X1

At the summit Tokyo will attempt to sidestep planned EC criticism of Japanese trade practices by using its position as host to focus the agenda on other issues. Tokyo remains unwilling to meet the primary EC demand of setting targets for increased imports of EC goods but hopes increasing Japanese investment and technical cooperation will hold trade tensions to a manageable level. 25X1

7 **International Financial Situation: Iraqi Debt Payments Straining Finances** 25X1

To reduce the growing gap between revenues and expenditures, Iraq will have to cut 1986 imports and press creditors for further rescheduling of payments due this year. Iraq is looking to Saudi Arabia and Kuwait to increase their financial aid this year, but belt-tightening at home probably will prevent these countries from fully offsetting the decrease in Iraqi oil revenues. 25X1

11 **Sudan: An Economy Unhinged** 25X1

Abject mismanagement of economic affairs by Sudanese officials has, in recent months, weakened an already tottering economy and threatens to quickly erode popular support for the new elected civilian government. While the new government will undoubtedly attempt to tackle the many severe economic problems facing Sudan, we doubt that it will be strong enough or capable enough to redirect the economy or enforce belt-tightening. 25X1

15 **Mozambique: Economic Impact of the Insurgency** 25X1

Mounting insurgent activity has created severe problems for Mozambique's already weak economy. Reacting to the economic crisis, President Machel's government has initiated a limited reform program, but GDP will continue to decline in 1986, in our judgment. 25X1

25X1

25X1

International Economic & Energy Weekly

25X1

18 April 1986

Perspective

Internationalization of World Industry

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Over the past several decades, corporations—both US and foreign—have found it increasingly necessary to form alliances with foreign firms in order to remain competitive. Reasons for these shifts include:

- Penetrating protected markets and reducing trade frictions.
- Cutting production costs by sourcing in countries with low costs.
- Seeking access to advanced technologies and/or manufacturing processes.

The growing international linkages among firms cover a wide variety of business activities, including joint ventures, original equipment manufacture agreements, R&D agreements, and equity positions and mergers. Many agreements transfer technology through patent exchanges, cross-licensing, and technical assistance. 25X1

Key sectors of most industrialized economies are experiencing the impact of internationalization. In mature industries:

- The major ***commercial aircraft*** companies continue to seek foreign partners not only to defray the huge development cost and risks associated with the launching of new designs but also to assure an entree to their partners' markets.
- Increasing linkups of ***automobile*** firms have been spawned by market access restrictions and the need for low-cost production bases. In Western Europe, financial pressures are forcing automakers to increase the use of cooperative ventures to achieve economies of scale and rationalize production.
- Growing international competition has led to a shakeout of ***machine tool*** producers. Small, marginal producers are dropping out and US firms have sought links to Japanese and West European competitors to survive.

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Although most visible in the mature industries, the same process is rapidly occurring in the high-technology sector:

- Many ***semiconductor*** firms, particularly in the United States, are dropping out of the high-volume memory market and/or forming joint ventures with Japanese or European firms, because they are unable to continue the high investment in R&D and capital equipment with shortening life cycles.
- To survive, once fiercely independent ***computer*** companies are scrambling to form alliances and partnerships to broaden their product ranges. Moreover, R&D costs have become too large for most computer firms to bear alone.
- In ***telecommunications,*** growing deregulation and rapid advance in technology are prompting dramatic changes in the structure of the industry. Firms are forming alliances to offer complete product lines and services at competitive prices and to gain access to restricted foreign markets. 25X1

The motivations for entering into strategic alliances can differ widely across countries, industries, and companies. Not only economic factors, such as exchange rates, but also government trade and investment policies play a major role. In general, the Japanese are increasingly entering into international alliances to maintain or improve market access while tempering protectionist sentiment. For their part, West European governments and firms have banded together in regional R&D programs, such as Eureka and Esprit, to regain competitiveness and greater independence. At the same time, however, many large European firms, such as Olivetti and Philips, have formed alliances with US and Japanese firms to acquire product and process technologies and gain access to their markets. US companies, squeezed by high capital costs, low profits, and foreign competition, are looking abroad to defray R&D and investment costs. [redacted] 25X1

The growing number of international industrial alliances is leading to a rapid shift of production capabilities and technology from one country to another. As a result, international groupings may be increasingly independent of government control when deciding where to produce and sell advanced-technology products, penetrate new markets, or transfer dual-use technology. In particular, as US technology becomes embodied in the products of such industrial groupings, US export controls will lose their ability to influence sales to Communist countries. Furthermore, to the extent extraterritorial groupings operate outside the framework of international trade agreements, such as GATT, the United States will in the future be more concerned with corporate than government trade policies. [redacted] 25X1

[redacted] 25X1

Summit Issues: EC-Japanese Trade Tensions

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At the summit, Tokyo will attempt to sidestep planned EC criticism of Japanese trade practices by using its position as host to focus the agenda on other issues. We expect Tokyo to generally have its way; the EC is likely to voice its complaints only in private sessions to prevent embarrassing Prime Minister Nakasone, who is angling for a third term. Tokyo remains unwilling to meet the primary EC demand of setting targets for increased imports of EC goods but hopes increasing Japanese investment and technical cooperation will hold trade tensions to a manageable level. 25X1

European Community: Balance of Trade With Japan, 1981-85 *Million US $*

	1981	1982	1983	1984	1985
European Community	**−10,719**	**−10,158**	**−10,880**	**−10,364**	**−11,449**
West Germany	−3,526	−2,655	−3,469	−3,930	−3,954
United Kingdom	−2,052	−2,935	−3,047	−2,403	−2,893
France	−1,042	−1,099	−708	−701	−749
Italy	−57	76	109	16	−42
Other EC	−4,042	−3,545	−3,765	−3,346	−3,811

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Recent Developments

West European leaders generally remain irritated with Japanese trade practices. They view Tokyo's recent trade concessions as mostly window dressing and believe that the measures will do little to reduce last year's $11.4 billion trade deficit with Japan. In three high-level meetings over the last nine months—Nakasone's tour of Europe last summer, the EC-Japanese Ministerial in November, and EC Commission President Delors' visit to Tokyo in January this year—the West Europeans cited unfair Japanese trade practices as the primary reason for the large bilateral deficit. EC officials accuse Japanese companies of dumping to gain a foothold in European markets while Tokyo protects Japanese manufacturers from import competition.

The Community's response thus far has been to:

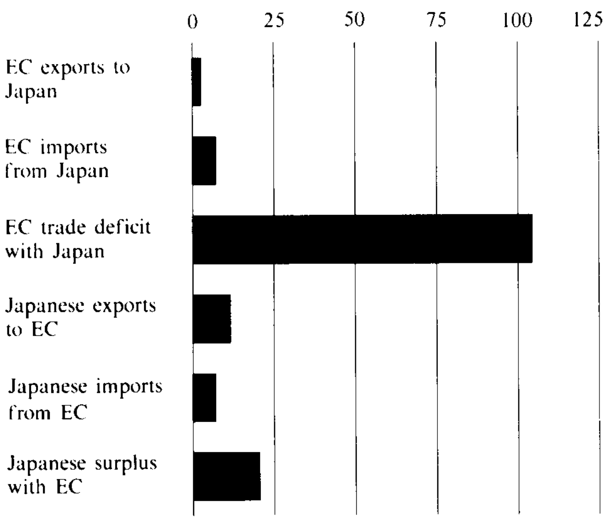
- Pressure Japan to set targets for increasing imports of manufactures and processed agriculture products.
- Increase the use of antidumping measures against Japanese products. The EC decided in January to extend its import surveillance program for certain Japanese products—including stereos, light commercial vehicles, and forklift trucks.
- Seek the support of others against the Japanese. Last month, the EC representative to the GATT Preparatory Committee made a formal proposal that, in effect, would have placed Japanese trade practices on the agenda for the new trade round.

In addition, the EC's Council of Foreign Ministers recently announced that there will be no EC trade concessions during the new GATT round that benefit Japan unless Tokyo takes effective measures to reduce its trade surplus. 25X1

Tokyo, for its part, has granted minor trade concessions in an attempt to avoid more punitive EC measures. This year, for example, Tokyo agreed to "monitor" exports of several items—including machine tools and color televisions—and cut tariffs on 25X1

EC-Japan: Trade Significance, 1985 [a]

As a percent of total



[a] Estimated.

[redacted]

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some industrial imports from the EC as compensation for continuing import curbs on leather and leather products in violation of GATT guidelines. This settlement, however, was much less favorable than the US-Japanese agreement on the leather issue. Tokyo also agreed in January to set up research cooperation with the EC and establish a center to promote industrial cooperation and technology transfer to Community members. [redacted] 25X1

The Japanese, however, have refused to consider the Community's most important demand—import targets for European products. [redacted] 25X1 [redacted] Nakasone and Foreign Minister Abe strongly oppose this approach to solving EC-Japanese trade problems, and Tokyo's response has been that even estimated, nonbinding figures would violate free-trade principles. [redacted] 25X1

Community leverage over Japan on trade is relatively weak because the Japanese still view the EC market as much less important than the US market. Tokyo fears that any concessions to the Community would set a costly precedent for negotiations with the United States. Nakasone, whose party faces an election later this year, is also worried about the domestic political impact of any Japanese trade concessions. Moreover, the relatively restrained EC response thus far has probably convinced the Japanese that they can continue to contain the dispute without major concessions to the Community. [redacted] 25X1

At the Summit

Although Japan has successfully avoided EC criticisms of its trade practices at past summits, we expect Community leaders to press their trade grievances with Tokyo during private summit meetings. EC Commission President Delors will probably lead European efforts, arguing particularly for Japan to boost its imports of manufactured goods and to stimulate domestic demand. We believe that three of the EC Summit participants will join in criticizing Japanese trade practices—the United Kingdom, France, and Italy. [redacted] 25X1 25X1 Prime Minister Thatcher has been upset with Tokyo since British firms lost out to Japanese firms last year on the Bosporus bridge contract in Turkey. She claims that government subsidies were the key to the successful Japanese bid. The French have been the strongest critics of Japan in the Community, but the power struggle between President Mitterrand and Prime Minister Chirac may act as a restraint on French statements. [redacted] 25X1

Overall, Community criticism of Japan will be tempered somewhat by several other factors. West Germany, with its own large global trade surplus—$25 billion last year—does not support protectionist measures against Japan and, therefore, is unlikely to participate in the attacks. Also, the EC has benefited from a substantial increase in Japanese direct investment in Western Europe over the last few years—from $484 million in 1983 to $1.9 billion in 1984—and will want to keep these funds flowing to ease its historically high unemployment. Perhaps most important, EC Commission officials are unlikely to criticize Nakasone publicly because they do not want to undercut his initiatives to increase imports. 25X1

Tokyo will attempt to deflect EC criticism on trade issues at the summit by using its position as host to focus the agenda on other matters, such as the political communique, LDC debt, and international monetary issues. Nakasone will almost certainly talk up the recommendations of his special advisory commission on trade policy, the Maekawa Commission, which calls for reducing Japan's current account surplus. In addition, Tokyo probably will float a proposal to establish a multinational center to promote cooperative research in biotechnology. 25X1

Beyond the Summit

Community officials can be expected to use every opportunity to keep the pressure on Tokyo to change its export-based economic policies. The EC probably views the new GATT round as the most effective forum to garner support from other dissatisfied Japanese trading partners. Tokyo will continue to rely on increases in Japanese investment in EC nations and on promotion of expanded industrial and technical cooperation between Japan and the Community to keep trade frictions to a moderate level. 25X1

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International Financial Situation: Iraqi Debt Payments Straining Finances [redacted]

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The sharp decline in world oil prices is seriously disrupting Baghdad's ability to manage its foreign debts. Lower oil earnings have caused a large shortfall in the foreign exchange earnings Baghdad needs this year to make large payments for goods imported on credit and to meet rescheduled debts to foreign lenders. To reduce the growing gap between revenues and expenditures, Iraq will have to cut 1986 imports and press creditors for further rescheduling of payments due this year. Iraq is looking to Saudi Arabia and Kuwait to increase their financial aid this year, but belt-tightening at home probably will prevent these countries from fully offsetting the decrease in Iraqi oil revenues. [redacted]

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Payments Crunch in 1986

The slide in Iraqi oil revenues and foreign exchange reserves since 1982 has forced Baghdad to resort to deferred payments for nearly all civilian imports. Despite Iraq's financial difficulties, its trading partners had extended credit in anticipation of higher oil revenues from the Iraqi-Saudi pipeline that opened in October 1985. Sharply lower oil prices, however, have turned the tables on Baghdad and its creditors. Assuming a $15 per barrel average oil price, we estimate Iraqi oil revenues will fall from $11.4 billion in 1985 to about $8.5 billion this year, even with an increase in oil exports of some 350,000 b/d. Iraqi oil exports are near capacity and cannot be increased substantially until mid-1987, when a second pipeline through Turkey is completed. [redacted]

To adjust to lower oil revenues, we believe Iraq will have to slash imports by roughly 25 percent this year and, in addition, find a way to cut some $2.2-2.7 billion of the $9 billion in payments—including civilian and military—due this year. Baghdad has begun to miss payments and is pressing creditors to extend repayment periods. [redacted]

Iraq:
Foreign Payments, 1986

Billion US $

	Amount
Foreign exchange requirements	17.0
Payments for civilian imports	8.5
Payments due on civilian development project debt	2.0
Military imports and debt	3.0
Invisibles [a]	3.5
Foreign exchange revenues	11.8
Oil exports [b]	8.5
Nonoil exports	0.3
Arab aid [c]	3.0
Financial gap	**5.2**
Financing the deficit	
Reduced civilian and military import payments	2.2-2.7
Rescheduling civilian project debt	1.5-2.0
Reduced remittances to foreign workers and reduced foreign travel	1.0

[a] Includes remittances to foreign workers, interest on debt, and transportation fees.
[b] Assumes oil exports of 1.55 million b/d at $15 per barrel.
[c] Estimated.

[redacted]

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For imports this year, Iraq has asked several suppliers to reopen negotiations on existing contracts to lower the amount originally ordered. The US Embassy in Baghdad reports that Iraq informed a Japanese company that the amount of textiles Iraq contracted for must be reduced by 30 percent. Most of the cuts will fall on goods for domestic industry and ongoing development projects. In addition, Baghdad hopes to save about $1 billion this year by reducing the amount that foreign workers are allowed to remit. [redacted] 25X1

Iraq has so far been unsuccessful in obtaining new longer term, low-interest loans to lower the cost of future consumer imports. The US Embassy in Baghdad reports that the USSR and East Germany rejected an Iraqi request to provide 10-year credits, and several Bloc countries have yet to agree to provide four-year credits. Turkey, one of Baghdad's largest suppliers, so far has refused an Iraqi request to double the repayment period on future credits to two years. [redacted]

Iraq: Payments for Civilian Imports, 1983-86 *Million US $*

	1983	1984	1985	1986 [a]
Imports [b]	9,500	8,900	9,000	6,500
Total payments due	**4,750**	**4,600**	**7,063**	**8,463**
Cash down	4,750	2,225	1,350	1,300
Deferred from 1983	0	2,375	2,375	0
Deferred from 1984	0	0	3,338	3,338
Deferred from 1985	0	0	0	3,825

[a] Assumes 1986 imports are cut by roughly 25 percent and that a cash downpayment of 20 percent is made.
[b] Since 1982, yearly import financing has been accomplished by an initial cash downpayment, with the remainder due in two equal annual installments.

[redacted] 25X1

Creditors Growing Wary

We believe Iraq will be able to reschedule most of the $2 billion owed its foreign creditors this year for past development projects but probably will not be able to secure additional commercial loans to supplement import credits over the next year. According to the US Embassy in Baghdad, Iraq has not made $225 million in debt repayments due this month to West Germany and France. Baghdad owes about $1.5 billion this year to West Germany, France, and Japan. The US Embassy reports that West Germany and Japan have indicated that they will accommodate Iraqi rescheduling, but Japan wants a higher interest rate and shorter repayment period than Baghdad has offered. France, one of Iraq's largest military suppliers, is owed about $500 million and is also likely to go along. We believe that lender willingness to once again reschedule Iraqi debt—most of which was originally rescheduled in 1983 and 1984—reflects their belief that Baghdad will continue to miss scheduled payments if no agreement is reached and that Iraq's oil reserves ensure that they eventually will be repaid. [redacted]

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Baghdad's creditors, nonetheless, are becoming increasingly worried about Iraq's deteriorating financial condition, despite its potential as a lucrative long-term market. The US Embassy in Baghdad reports that Iraq obtained a $500 million Euroloan this past fall only after Baghdad applied significant pressure on the Gulf Investment Bank, partially owned by Iraq, to provide a large portion of the loan. [redacted] 25X1

Outlook

The short-term structure of Baghdad's debt to non-Arabs and growing creditor resistance are threatening Iraq's strategy of playing off lenders to obtain reschedulings. Most of Iraq's $9-10 billion debt outside the Arab world is due over the next three years. Baghdad probably will be able to increase oil revenues when the second pipeline through Turkey comes on stream next year. Nonetheless, weak oil prices are pushing Iraq closer to default and may soon force Baghdad to ask its key creditors to

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accept a large-scale rescheduling agreement. [redacted] 25X1

Baghdad is counting on continued large-scale financial support from Saudi Arabia and Kuwait, especially while Iran holds Al Faw. Riyadh and Kuwait have renewed an agreement to sell oil on Iraq's behalf—which brought in about $2 billion in 1985—and have given Baghdad large cash infusions. Belt-tightening in both countries, however, will cause Riyadh and Kuwait to force Iraq to get by on less, and their aid will not be sufficient to stave off deep import cuts. [redacted] 25X1

[redacted] 25X1

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Sudan: An Economy Unhinged [redacted]

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Abject mismanagement of economic affairs by Sudanese officials has, in recent months, weakened an already tottering economy and threatens to quickly erode popular support for the newly elected civilian government. Sudan's public-sector economy, on whose payrolls and subsidies many politically vocal urban Sudanese depend, is rapidly going bankrupt, the victim of diminished donor assistance and failed government policies. Meanwhile, Sudan's unofficial economy continues to thrive, but has come under increasing assault by the regime and may be less able to cushion the population from commodity shortages in the future. While the new government will undoubtedly attempt to tackle the many severe economic problems facing Sudan, we doubt that it will be strong enough or capable enough to redirect the economy, or enforce belt-tightening. [redacted]

Debt Impasse

Failure to reach agreement with the IMF over an acceptable economic reform package, together with the dim prospects of reducing arrears—which had reached $244 million by January 1986—led to Sudan's formal exclusion in February from access to IMF resources. In practical terms, the IMF decision has changed very little in the relationship; Khartoum had been effectively barred from tapping IMF resources from the moment that arrears began to accrue in July 1984. Meanwhile, consultations between the Fund and Sudanese officials will continue, unaffected by the ineligibility declaration. The prospects for Sudan being able to implement an IMF-endorsed reform package in the near future are remote, however. The government is simply too weak to perform the control functions that an IMF program would require. [redacted]

The IMF declaration may have convinced many donors that any meaningful resolution of Sudan's debt problems is impossible, thereby affecting their willingness to provide the level and type of financial support Sudanese officials have come to expect. Paris Club rescheduling of official debt and London Club rescheduling of commercial debt is also likely to become more difficult in the absence of an IMF accord. Nonetheless, such rescheduling exercises are becoming increasingly irrelevant as Sudan's debt service capability continues to decline. [redacted] 25X1

Largely for political and humanitarian reasons, most major donors are likely to continue to disburse financial aid, albeit at reduced levels. The type of aid, however, will probably be influenced at least partially by the level of commitment the new regime displays toward economic reform. If, as seems likely, the new government remains wedded to a state-dominated economy, some donors may choose to limit direct balance-of-payments support. Project-related assistance, on the other hand, will 25X1
probably continue. [redacted] 25X1

Recent Policy Moves

Domestic policy initiatives pursued by the outgoing transitional government either have proved ineffectual, or have set the stage for further serious problems. Budgetary measures announced over the past several months have largely centered around increasing government revenue through closing tax loopholes and instituting new taxes. Most of these measures will generate much less revenue than anticipated because the government is not strong enough to enforce these regulations effectively. Aside from the problems of lax enforcement and corruption, the government's control, for the most part, extends only slightly beyond the outskirts of Khartoum and the Gezira region to the south. Beyond this narrow corridor, smuggling and black markets financed through illegal foreign exchange 25X1
transactions dominate the economy. [redacted] 25X1

The transitional government has also attempted to expand its control over foreign exchange remittances, at least within the Khartoum area, by prohibiting private businesses from importing goods financed through the black, "private" foreign exchange market. Theoretically, businessmen can now finance imports only with foreign exchange obtained through the banking system at a government set rate. To ensure fairness, a banker's committee has been created to establish a "free market" rate at which remittances can be bought or sold. 25X1

Implementation of these foreign exchange regulations has proved a disaster. It has led, according to US Embassy sources, to a drastic reduction in the supply of foreign exchange, massive capital flight, and a reduction in customs revenues. Imports, which averaged $7 million per week and kept the economy limping along, have now declined by 90 percent. Embassy sources estimate capital flight over the past month at more than half a billion dollars. Finally, the government controls have pushed the black-market rate from 4 pounds per dollar to more than 5. Although the Banker's Committee belatedly changed the official "free market" rate from 3.3 per dollar to 4.3, the new rate remains sufficiently below the black-market rate to discourage conversions at the new government rate. 25X1

Sudan:
Balance of Payments, 1985-86

Million US $

	1985 [a]	1986 [b]
Current account balance	−455	−555
Trade balance	−656	−655
Exports (f.o.b.)	544	595
Cotton	244	270
Other	300	325
Imports	1,200	1,250
Service balance	−123	−175
Receipts	650	600
Remittances	430	375
Other	220	225
Payments	773	775
Official transfers	324	275
Capital account	−350	−375
Financing gap	**805**	**930**

[a] Estimated.
[b] Projected.

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Prospects for the New Government

The new government must act quickly to deal with the foreign exchange crisis. A unified exchange rate would remedy the situation, but it is unlikely that the new regime would attempt such a radical solution. More likely, a return to a two-tier exchange rate system with the black market officially tolerated is the best that can be expected. This will, at least, produce a resumption of remittance flows at previous levels and allow Sudan's fairly resilient private economy to supply the basic import requirements of the population. 25X1

Toleration of the black market will not, of course, resolve the problem of supporting Sudan's bloated civil service or subsidizing consumer goods for urban populations. The financial plight of the public sector is likely to grow worse, particularly in light of the probable decline in balance-of-payments support from abroad. Moreover, government efforts in recent months to support this sector through exponential expansion of the money supply will almost certainly fuel inflation (currently running at over 50 percent at an annual rate) and contribute to another round of labor unrest and—possibly—civil disturbances. It is also possible, however, that the growing financial squeeze in the public sector may force the new government to set a more realistic official exchange rate and allow the private sector to take on greater responsibilities. 25X1

While the new government wrestles with ways to resolve its economic difficulties, domestic pressures to improve relations with Libya will continue. Tripoli has already provided 2.2 million barrels of crude to Sudan over the past six months and has used its economic leverage to expand its political influence in Khartoum. The recent Saudi decision to provide, gratis, 2.9 million barrels of oil—or most of Sudan's petroleum requirements through June—has temporarily eased the government's reliance on Libyan largess, but an increasingly bankrupt Sudanese regime will probably not hesitate in the future to accept further Libyan assistance if no other sources of aid are available—even at the risk of increased Libyan influence in Sudan. [redacted] 25X1

[redacted] 25X1

Mozambique: Economic Impact of the Insurgency 25X1

Mounting insurgent activity over the past three years has created severe problems for Mozambique's already weak economy. Attacks by the Mozambique National Resistance (RENAMO) have disrupted rail, road, and port transportation, reduced mine and farm output, caused electric power outages, enlarged refugee populations, and led to devastating food shortages. Falling exports and earnings from transport services for neighboring countries have caused severe foreign exchange shortages and forced Maputo to make major cuts in imports. Finance Minister Alves reported in December 1985 that GDP contracted by 20 percent last year despite the end of a severe drought. Reacting to the economic crisis, President Machel's government has initiated a limited reform program designed to increase the role of the private sector and reduce the inefficiencies of the socialist economic system. Although production has increased somewhat, GDP will continue to decline in 1986, in our judgment. We believe economic problems will fuel a growing political threat posed to the Machel government.

Attacks on Economic Targets

Land transportation facilities have been major insurgent targets. Rocket fire, derailments, mines, and blown-up bridges have closed the main rail lines from Maputo to Zimbabwe and from Mozambique's northern port of Nacala to Malawi for more than a year each. Also closed or operating at sharply reduced rates are the three rail lines from the port of Beira to terminals in Zimbabwe, Malawi, and at domestic coal mines and farms in the Mozambican province of Tete. Attacks have repeatedly interrupted traffic on the two cross-country railroads from Maputo to South Africa and Swaziland. Insurgent activity has also forced road traffic to travel in armed convoys.

Although Mozambique's three ports have not been seriously damaged, reduced rail traffic and electric power outages because of the insurgency have contributed to a steep fall in port shipments. Attacks against electric power lines to Maputo in January, for example, slowed loading for more than a week. Tonnage handled through Maputo has dropped by about two-thirds since 1982, according to our estimates based on US Embassy reporting. Beira is being used at about half of its capacity of 3.3 million metric tons per year, according to press and IMF reporting. Malawian trade normally shipped through Nacala has been diverted to South African ports. 25X1

RENAMO's destruction of over 500 pylons on the electric power line to South Africa has virtually shut down Mozambique's Cabora Bassa hydroelectric complex. Railroad closures cut coal production at Vila Moatize from 500,000 tons in 1980 to 20,000 tons in 1985. Tantalum mining at Morroa in Zambezia Province has been at a standstill since the kidnaping in late 1983 of 24 Soviet geologists 25X1
there. 25X1

Severe Food Shortages

On top of the alternating drought and floods over the past few years, RENAMO attacks have caused deep cuts in production of food and export crops. Attacks on farm installations and road transport, for example, cut corn harvests on one large state-owned farm complex from an average 10,000 tons annually to 500 tons in the current harvest season, despite a sharp improvement in weather. Farmers abandoning their land because of insurgent pressures have more than doubled the population of

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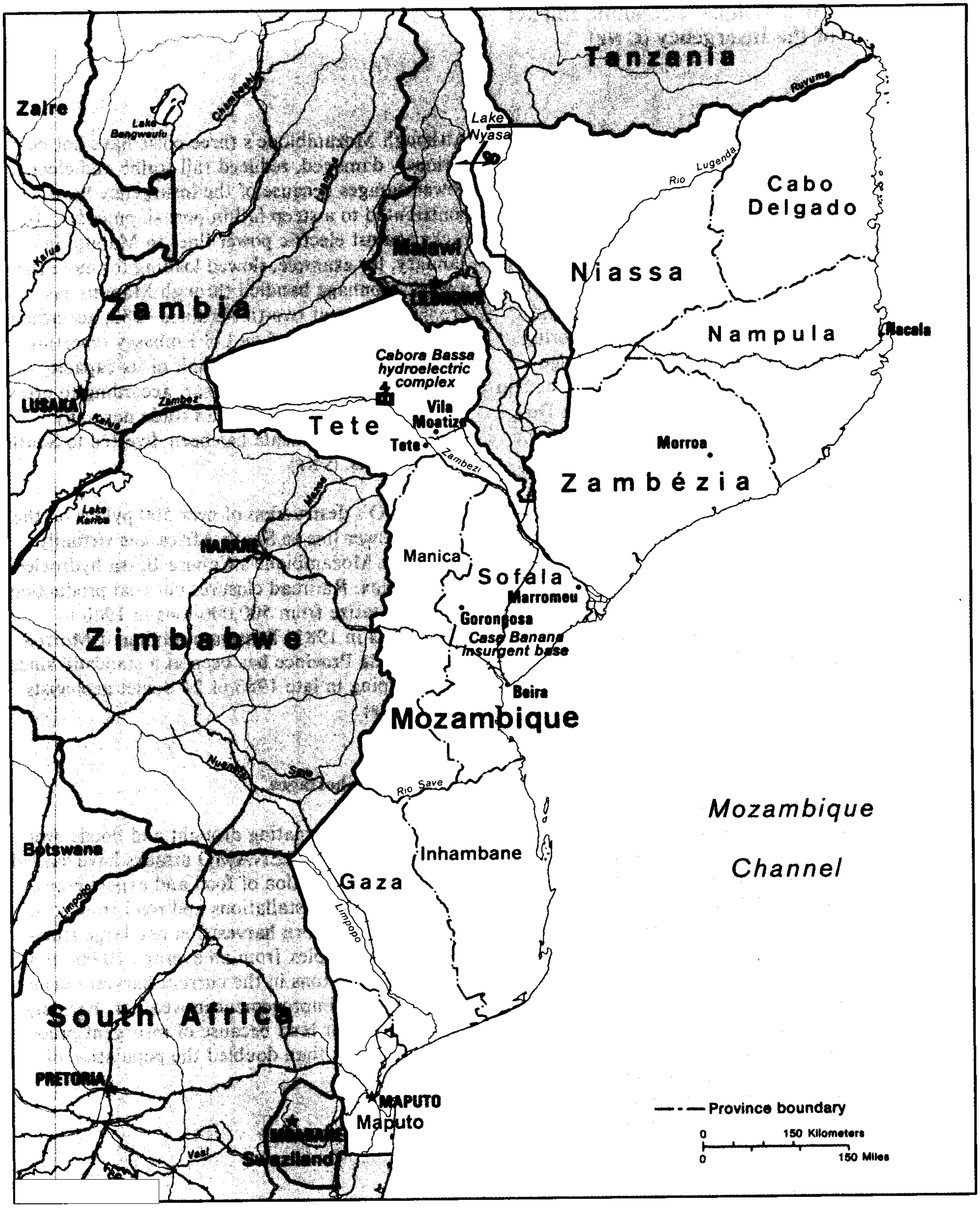

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Moatize to about 75,000 persons, according to US Embassy reporting. In January, insurgents destroyed the sugar refinery at Marromeu, one of only three in the country that had still been operating. [redacted]

Drought cut harvests of corn, rice, and other staple crops in half in 1984, according to US Embassy reporting. We expect a further decline during 1985-86 because of the insurgency, and grain marketing in the crop year beginning this May is projected by the Food and Agriculture Organization to total only about 80,000 tons, little more than one-tenth of requirements. Foreign exchange shortages forced Maputo to cut commercial imports of grain from more than 200,000 tons in 1980 to only 29,000 tons in 1985 and to increase heavily its dependence on foreign aid to meet minimum food requirements. [redacted]

Foreign Exchange Constraints

The impact of the insurgency on the country's ability to earn foreign exchange has hurt the economy more than direct damage from armed attacks, in our judgment. Sketchy data indicate that exports declined from about $230 million in 1982 to only $75 million in 1985. The shutdown of cross-country railroads, moreover, has slashed foreign exchange earnings from services, which historically had offset large merchandise trade deficits. Maputo has reacted by cutting imports by nearly one-fourth since 1982. The large current account deficit was covered by foreign aid inflows and a rapid buildup of arrearages on foreign debt repayments. Central to Mozambique's bleak economic performance is its loss of competitiveness in providing services to South Africa and other neighboring countries. Spurred by the deterioration of services following Mozambique's independence in 1975, the South African Government and private firms have constructed major alternative facilities. [redacted]

Shortages of imported commodities have caused production losses throughout the economy:

- A variety of press and US Embassy reports indicate that shortages of fuel and spare parts have idled large numbers of farm tractors.

Mozambique: Balance of Payments *Million US $*

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	1982	1983	1984	1985 [a]
Current account	−577	−505	−476	−610
Trade balance	−607	−504	−444	−575
Exports	229	132	95	75
Imports	836	636	539	650
Net services	30	−1	−32	−35
Capital account	395	69	−144	−150
Financial gap	**182**	**436**	**620**	**760**

[a] Estimated.

[redacted] 25X1

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- Four of the five sawmills in Cabo Delgado Province are inoperable because of lack of maintenance and spare parts, according to US Embassy reporting.

- Fuel shortages have also hamstrung a program to distribute clothing and other consumer products to rural areas as barter for farm crops. With nothing to trade, local officials have been unable to induce farmers to increase planting for urban food markets. Cashew nuts have fallen from first to third among Mozambique's exports as harvesting has declined by more than three-fourths since 1982.

- Shortages of raw materials, fuel, and spare parts have severely restricted manufacturing production. Capacity utilization in various industries has ranged from 10 to 40 percent during the past few years. [redacted] 25X1

The cuts in imports and the fall in industrial and farm production have shrunk the tax base significantly. As a result, government revenues have fallen by nearly half since 1982 to about $380 million in 1985. Despite this reduction, the pressing need to battle the insurgency induced the government to increase military spending by 9 percent in 1986 to 42 percent of budgeted expenditures. In 25X1 contrast, Mozambique has closed large numbers of schools since 1983 because of funding shortages. [redacted]

Government Reaction

Rising concern over the continuing economic deterioration induced the Machel government to launch a limited economic reform program in early 1983. The program, which is designed to increase the participation of private firms in the economy and attract foreign investment, has five elements:

- Distributing agricultural land from state farms to cooperatives and private farmers.
- Increasing selected prices, particularly of foodstuffs, to encourage production and marketing.
- Returning some nationalized manufacturing firms to private ownership.
- Strengthening Western economic ties by joining international financial organizations such as the IMF and IBRD and soliciting private investment by US and other Western firms.
- Reestablishing economic ties to South Africa.

[redacted]

Steps taken to implement the program thus far indicate that the Machel government is willing to make a substantial effort toward increasing Western and South African ties and stimulate production by reducing government control. In 1984, Mozambique joined the IMF, IBRD, and the Lome Convention, signed an investment insurance agreement with the United States, and enacted a liberalized investment code that guarantees profit repatriation and offers tax incentives to potential investors. Maputo also signed an accord with South Africa in 1984 designed to end South African aid to RENAMO and attract South African investors. Following these initiatives, the Paris Club agreed to reschedule Mozambican debt in October 1984, and the IBRD granted a $45 million loan in 1985. Maputo currently is considering IMF conditions for a standby agreement. Progress has also been made on distribution of state-owned land and on increasing agricultural prices. [redacted]

The government also has turned over more than 20 manufacturing firms to local businessmen, and a small number of US and other foreign firms are interested in investment projects. 25X1 The UK-based London Rhodesia Company (LONRHO), which has large farm and industrial investments in neighboring southern African countries, has begun projects in farming, mining, tourism, and railroad rehabilitation that may total $30-40 million by 1990. US firms have undertaken preliminary oil exploration activities and are looking at mining and farming projects. South African firms have completed feasibility studies for a 4,000-hectare farm project, and a Zimbabwean firm has entered a small joint venture project with the Mozambican government to mine bauxite. [redacted] 25X1

Gloomy Outlook for 1986

During 1986 the economic impact of insurgent attacks will continue to outweigh the positive effects of Maputo's limited reform program, in our judgment. We believe that Zimbabwe's decision in February to withdraw its forces from large-scale 25X1 offensive operations in Mozambique has cleared the way for RENAMO to resume attacks on roads, trucks, and farms in the central third of the country. As a result, the problems of distributing farm inputs such as fertilizer and spare parts and of moving farm products to urban markets over the already badly disrupted transport system will worsen. Mozambique's food imports will plummet in 1986 because of foreign exchange shortages, and the country will require about 450,000 tons of food aid deliveries, according to US Embassy reporting. Fuel shortages probably will worsen this year because requirements for arms imports and servicing of the massive foreign debt, which now exceeds $2.4 billion, according to US Embassy reporting, will continue to drain foreign exchange. [redacted] 25X1

The insurgency and the foreign exchange crisis also will undermine any positive effects from the return to private ownership of urban businesses and the

25X1

enthusiasm of private foreign investors. Fuel, electricity, and raw material shortages will continue to hamper factory output. Major investors will have to bear significant additional costs for security because of the Army's inability to provide protection. [redacted] 25X1 Private farmers also are providing room and board to Army troops in return for protection. [redacted] 25X1

We believe Machel is acutely aware of the negative impact of his government's socialist policies. In a speech to the Mozambican People's Assembly, he criticized "ultra-leftist errors" that had reduced food production by interfering with the distribution of tractors and other farm inputs to private farms and cooperatives. Machel's concern with redressing the shortcomings of the socialist system, however, has little chance of offsetting the economic impact of the insurgency, in our judgment. As a result, we expect the economy to contract again this year, adding to the major political threat to the Machel government. [redacted] 25X1

[redacted] 25X1

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International Natural Rubber Agreement: Muddled Prospects for New Accord [redacted]

25X1

The recent collapse of the international cocoa and tin agreements provides a dismal backdrop for next month's renegotiation session of the International Natural Rubber Agreement (INRA), the first of a series of meetings over the next year to replace the current pact, which expires in October 1987. Negotiations will be further complicated by the depressed state of the rubber market. Under these circumstances, little progress, or even failure, is likely given the wide gap between exporters' and importers' interests. [redacted]

25X1

Members of the International Natural Rubber Organization

Exporters	*Importers*
Indonesia	*Australia*
Ivory Coast	*Brazil*
Malaysia	*Canada*
Nigeria	*China*
Papua New Guinea	*Czechoslovakia*
Sri Lanka	*EC*
Thailand	*Finland*
	Iraq
	Japan
	Mexico
	Norway
	Peru
	Sweden
	Switzerland
	United States
	USSR
	Yugoslavia

[redacted]

25X1

An Agreement in Trouble

The six-year-old rubber accord—sponsored by the United Nations Conference on Trade and Development and designed to stabilize natural rubber prices—is the youngest of the market-intervention commodity pacts and, like the others, has been largely ineffectual. Although natural rubber prices have recovered somewhat in the first three months of 1986, they are still more than 40 percent below peak 1980 levels. Moreover, rubber price fluctuations have not been reduced appreciably. Indeed, despite buffer stock purchases, the International Rubber Organization (INRO), which administers the pact, has twice had to revise its price band downward—the last time by 3 percent last August. Moreover, the large quantity of rubber in the official INRA stockpile—about 360,000 metric tons or roughly one-tenth of annual non-Communist usage—is having a depressing effect on prices. [redacted]

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Agreements: Limited Comparisons

The market structure for natural rubber resembles that of tin—a commodity whose international agreement failed completely late last year. Both markets are dominated on the export side by Malaysia, Indonesia, and Thailand and on the import side by the United States, Japan, and the EC. The forces that underlie the tin crisis also appear to be at work in the market for natural rubber. The dramatic erosion of market shares by competing materials led to stagnant demand—since World War II synthetic rubber has captured two-thirds of the market. The leveling-off of demand growth did not, however, bring a concurrent reduction in production growth. [redacted]

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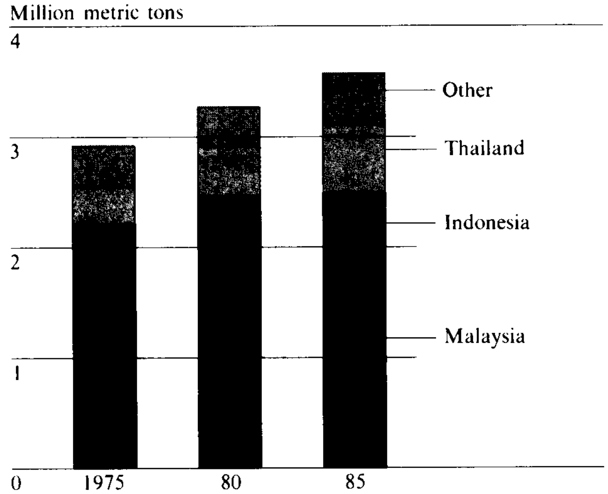
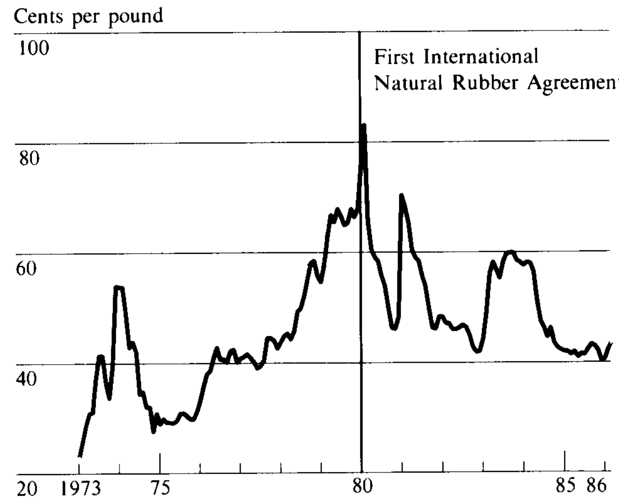
Nonetheless, the two commodity accords differ in several key areas. Both attempt to control prices through a buffer stock mechanism, in which a

Natural Rubber Exports



[redacted]
308876 4-86

Natural Rubber Prices, 1973-86 [a]



[a] Average monthly prices through March 1986.

[redacted] 25X1
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buffer stock manager attempts to keep prices in a predetermined range by buying or selling the material on the open market. Unlike under the International Tin Council, however, the INRO buffer stock manager is not allowed to operate in the highly volatile futures market; nor does the INRO borrow money from financial institutions. As a result, the INRO is less exposed financially than the tin council and is therefore less vulnerable to a sudden loss of confidence like that which hit the tin agreement. The rubber agreement also bars producing members from restricting production and exports, while the tin council allows its producing members to do so. [redacted]

Producers Divided

Under this dismal atmosphere of failed commodity accords and gloomy market prospects, the key exporters cannot agree on a preferred future course of action. Malaysia, the world's leading natural rubber producer, accounting for 35 percent of world output, would like to have export and/or production controls in the INRA but will reportedly not press this demand in the renegotiating sessions. Export and production controls would serve to guarantee Malaysia its current market share. Indonesia and Thailand, with greater growth potential, oppose production restrictions. [redacted] 25X1

Even if unanimity among the major producers existed, their bargaining position vis-a-vis importing countries would still be weak. Falling export earnings from other commodities and sizable debt burdens place growing pressure on Malaysia, Indonesia, and Thailand to maintain natural rubber sales. In particular, the rapid drop in oil prices will place an added demand on Indonesia and Malaysia, who depend on fuel revenues for roughly 75 and 25 percent of their total export earnings, respectively. 25X1
[redacted] 25X1

Domestic considerations also ensure plentiful supplies:

- In ***Thailand*** the rubber industry employs, directly or indirectly, more than one-half of the work force in the politically important southern region of the country. Last year the government cut export taxes to improve the competitiveness of its rubber. Bangkok also launched ambitious schemes to substitute rubber for unprofitable tapioca and sugar. Official goals aim to increase rubber production 35 percent by 1990 and an additional 40 percent by the year 2000.

- ***Indonesia*** is also opening up new areas for rubber cultivation. According to government statements, the intention is to broaden the natural rubber base by encouraging plantings on some of the smaller islands. This is being carried out in conjunction with the transmigration program, designed to resettle some half a million families.

The weak bargaining position of the rubber exporters is further exacerbated by the attitudes of the importing countries, led by the United States, who are now considerably less willing to support market-intervening commodity agreements. [redacted] 25X1

Outlook

In light of the tin crisis and the recently failed cocoa agreement renegotiations, questions concerning the viability of a new rubber agreement are sure to arise. It is apparent that, over the course of the next year, the rubber exporters' position will probably evolve to focus on an upward revision of the price band and on buffer stock management. Discussions of export and production controls probably will not even be given token consideration. On the importers' side, there is no compelling reason, other than the political one of appearing to support hard-pressed LDCs, not to be hard bargainers in upcoming sessions. If consumers are sufficiently unyielding, producers may decide that this forum is not worth the cost, adding natural rubber to the heap of failed commodity agreements. [redacted] 25X1

[redacted] 25X1

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Corporate Taxation and Industrial Competitiveness [redacted] 25X1

Although tax policy generally plays a smaller role in international competitiveness than such factors as exchange rates and labor costs, it is often an important factor over which corporations (and governments) can exert the most leverage. Currently, foreign tax laws offer firms no greater competitive advantage than US laws, but the financial and capital characteristics of foreign firms provide them significant tax savings. Foreign electronics firms reap large tax advantages from their greater diversification and use of debt. The past losses of many European auto companies will shelter them from taxes for the next several years, while all foreign automakers, except Toyota, benefit from their heavy use of debt. Although corporate taxation is more frequently a function of the political strength of domestic industries and government revenue requirements than international competitiveness, governments have actively encouraged various activities such as regional development and high-technology industry through the tax code. Moreover, recent tax measures—implemented or contemplated—by industrial countries threaten to restore the tax advantage that the foreign competitors of US firms enjoyed before 1981. [redacted]

Mature High-Technology Industry. Our analysis of corporate tax burdens on examples of mature and high-technology industries—automobiles and electronics, respectively—indicates that, on average, West European firms (except West German) in both sectors have sharply lower while Japanese firms face comparable or higher tax burdens than those in the United States. High-technology companies, however—particularly those in Japan and the United States—argue that the tax code is biased against them because it fails to account for their special characteristics and investments:

- Depreciation provisions favor capital-intensive industries and fail to account for the rapid obsolescence of high-technology investments.
- The preferential tax treatment accorded debt favors less risky investments.
- Inadequate tax-loss provisions reduce the impact of tax incentives designed to encourage investment.

Our analysis indicates that, in practice, foreign electronics and automobile firms are on a more equal tax footing than those in the United States. This equality results largely from the greater diversification of foreign electronics firms and differing financial practices rather than less biased tax systems. US electronics firms tend to have higher tax burdens than US automobile firms because they are more labor intensive, invest relatively more in structures (compared to equipment), and finance a greater portion of investments with internal funds rather than debt. [redacted] 25X1

Depreciation systems in France, Japan, and West Germany are no more neutral than the current US capital recovery system. Foreign electronics firms, however, are more diversified than US electronics firms, and have capital structures very similar to their counterparts in the automobile industry. As a result, foreign electronics firms are less subject to 25X1
the bias favoring capital-intensive sectors conferred by accelerated depreciation. Even this gap may narrow because of the increasing capital intensity of US semiconductor firms and the proposed elimination of the US investment tax credit. [redacted] 25X1

On an overall basis, most foreign firms reap a large tax advantage through their extensive use of debt financing.[2] The ability of Japanese electronics firms, for example, to operate with higher debt levels than their US counterparts may provide

[2] Among foreign firms, Toyota is one of the few exceptions to the heavy use of debt. Some analysts have suggested that Toyota avoids the use of debt in order to reduce its susceptibility to government pressures to hold back exports or restrain its domestic market share. [redacted] 25X1

[redacted] 25X1

Measures of the Corporate Tax Burden

Percent

	Marginal Tax Rate—Equipment [a]	Marginal Tax Rate—Structures [a]	Marginal Tax Rate [a]	Average Tax Rate [b]	Taxes as a Share of Sales [c]
France[d]					
Thomson	21.4	30.5	23.7	8.8	0.3
Peugeot	8.2	11.9	8.8	NEGL	NEGL
Renault	11.3	16.2	12.2	NEGL	NEGL
Italy [e]					
Olivetti	34.5	34.8	34.5	9.4	1.6
Fiat	37.6	37.9	37.6	12.5	0.8
Japan [f]					
Fujitsu	55.8	57.9	56.2	42.8	5.2
Hitachi	67.4	69.9	67.9	40.8	4.3
NEC	40.6	42.1	40.9	31.2	2.6
Nissan	66.9	69.4	67.5	39.3	3.1
Toyota	67.5	70.0	67.8	48.6	5.7
United Kingdom					
ICL	22.3	22.7	22.3	7.1	1.0
BL [d]	8.3	8.4	8.3	4.0	0.2
West Germany [g]					
Siemens	38.9	46.4	39.7	33.7	2.7
Volkswagen	35.8	41.3	36.2	23.5	3.0
United States					
Hewlett-Packard	23.8	50.3	36.5	36.9	6.4
IBM	18.8	39.7	24.9	40.6	10.4
Motorola	23.1	48.8	29.3	23.7	2.2
Texas Instruments	20.7	43.8	32.3	32.1	3.4
Chrysler	19.8	41.7	24.2	1.1	0.1
Ford	19.0	40.2	19.0	29.2	2.7
General Motors	22.4	47.3	26.1	27.0	2.3

[a] Marginal calculations represent a point estimate of the impact of generally available domestic tax provisions on in-country investments, given individual country and company characteristics such as use of debt financing, relative use of equipment versus structures, dividend payout rates, inflation rates, and desired after-tax rates of return. Use of common inflation and rate of return assumptions would generally result in lower foreign marginal tax rates.
[b] Ratio of actual tax payments to earnings before taxes and interest after adjusting for different accounting and depreciation practices; generally, averages are based on publicly available financial reports over the 1979-83 period.
[c] Ratio of actual tax payments to sales; averages for the same period for which average tax rates are calculated.
[d] Large loss carryforwards for Thomson, Peugeot, Renault, and BL lessen the accuracy of marginal tax rate calculations, since future profits are sheltered by past losses. Until past tax losses are eliminated, the marginal tax rate of these companies is effectively zero. In Peugeot's last profitable year (1979) the firm's average tax rate was 26.5 percent and the ratio of taxes to sales, 1.6 percent. In Renault's last profitable year (1980) the firm's average tax rate was 19.4 percent and the ratio of taxes to sales, 1.1 percent.
[e] Italian companies are from time to time allowed to take extra depreciation to adjust for the impact of inflation. These measures are unlikely to affect marginal incentives, however, as they cannot be anticipated.
[f] The marginal tax rate for equipment that qualifies for the special 7-percentage investment tax credit would be approximately 10 to 16 percentage points lower than that for nonqualifying equipment.
[g] The 7.5-percent investment subsidy (20 percent for investments of less than DM 500,000) would reduce the marginal tax rates of both Siemens and VW to approximately 24 percent.

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Sources of Tax Advantage and Disadvantage: Differences from US Standards [a] [b]

Country	*Advantages*	*Disadvantages*
France [c]	High debt levels Depreciation—Equipment Diversification (Thomson)	Depreciation—structures
Italy	Regional incentives (Olivetti) Double taxation relief Depreciation—equipment and structures Diversification (Fiat)	Lack of R&D incentives Lack of investment incentives
Japan	High debt levels (electronics) Diversification (electronics)	High nominal tax rates Low debt levels (Toyota) Depreciation—equipment and structures No general investment incentives
United Kingdom	Low nominal tax rates High debt levels Double taxation relief (ICL)	Lack of R&D incentives No general investment incentives
West Germany	High debt levels Double taxation relief Regional incentives Diversification (Siemens)	High nominal tax rates Depreciation—structures

[a] Judgments pertain to individual country differences with the United States and should not be used for cross-national comparisons with reference to individual items. Assessments with respect to foreign R&D incentives assume enactment in the United States of provisions similar to those which recently expired.

[b] Advantages and disadvantages apply to all firms included in the study unless specially identified in parentheses.

[c] Large past losses might be considered a source of tax advantage for French companies as they will ensure that future profits will be sheltered from taxes for several years.

[redacted] 25X1

them significant cash flow benefits since taxes are less of a drain on corporate resources. The ratio of taxes to sales indicates that most Japanese companies reap significant benefits from their highly leveraged position. The ratio of taxes to sales for Fujitsu, for example, is half that of IBM. [redacted] 25X1

Corporate diversification and the ability to use losses from unprofitable subsidiaries to offset gains from profitable subsidiaries are important factors in the effectiveness of tax incentives. For example, most industry experts believe that diversified Japanese electronics firms have financed semiconductor R&D and investments with profits from other lines of business. Moreover, greater diversification also tends to mask the importance of narrowly focused foreign tax measures—while foreign incentives for some investments can be much more generous than broad US incentives, the tax savings is small relative to the size of the firm. In less diversified high-technology firms, the absence of a steady flow of profits may inhibit the ability of companies to take advantage of investment tax incentives, because no country offers an immediate rebate for current losses incurred. In recent years, however, not only high-technology start-up firms but also mature firms—particularly European and US steel and auto companies—have been unable to take advantage of tax incentives because of poor profitability.

Outlook and Implications. Although the competitive advantage that foreign firms vis-a-vis US firms derive from the tax code has narrowed in recent years, this gap could widen again. In the past year or so, foreign governments have added tax incentives to encourage research and development, the growth of high-technology sectors, and capital formation:

- ***France*** recently increased its tax credit for R&D expenditures and is replacing its system of accelerated depreciation with a general tax cut for reinvested profits.
- ***West Germany*** has instituted special depreciation incentives for the purchase of assets devoted to R&D.
- ***Japan*** has augmented its general R&D tax credits with a special tax credit to encourage the purchase of high-technology assets by small companies.

Furthermore, many countries, including the United States, are reexamining their tax systems to reduce possible biases and enhance international competitiveness. 25X1

We believe that tax reform proposals in the United States and other industrial countries would—if passed—restore the tax advantage enjoyed by foreign firms in the 1960s and 1970s, harming the competitiveness of US industry. If tax reform measures currently under discussion in Japan are carried out, the tax burden on Japanese corporations could drop substantially—press reports indicate that Tokyo wants to reduce the effective tax rate on corporate income to 40 percent from approximately 52 percent. West European tax systems on the other hand are unlikely to change significantly over the next several years; tax changes would provide little benefit to Europe's major electronics and automobile firms, which will pay little in the way of taxes anyway because of large past losses. 25X1

Relative tax reductions for Japanese automakers could increase their ability to fund large investments, expand their US production capacities, and 25X1 compete head-on with US automakers in upscale markets. Although US high-technology firms may be one of the few beneficiaries of tax reform efforts, their ability to compete in world markets could be threatened if Japanese companies are operating with much lower tax burdens. We believe the risk would be greatest for US merchant semiconductor manufacturers, which have benefited greatly from investment and R&D incentives and are particularly susceptible to changes in tax policies because of their rising capital intensity. 25X1

25X1

Briefs

Energy

British Cabinet Debate Over Falling Oil Prices

Sharp differences are emerging in the British Cabinet over how much electricity customers should benefit from falling oil prices and whether coal prices should also be cut. The Central Electricity Generating Board (CEGB) has said it could pass on savings of up to $730 million a year if permitted to switch from coal to oil. The CEGB is using the oil price decline to demand equivalent cuts in coal prices, but Energy Secretary Walker is worried that sharp reductions in coal prices would damage the coal industry, which is struggling to become profitable after last year's strike. Walker is willing to cut coal prices only if lost revenue is made up by additional government subsidies to the National Coal Board. Chancellor of the Exchequer Lawson opposes any additional coal subsidy and is probably worried that an electricity rate cut would be difficult to reverse if oil prices rebound. We expect a compromise that permits the Coal Board to offer some price reductions and allows the CEGB to pass on the savings to consumers, but further oil price declines would quickly reopen the debate.

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Algeria Lowers Gas Price

Algeria's willingness to reduce its prices for natural gas to France and Spain—at least through June—could lead to similar adjustments by Moscow and other West European gas suppliers. The US Embassy in Paris says Algiers and Gaz de France agreed last month to a 40-percent reduction in the cost of Algerian gas, which would be tied to spot market oil prices. The US Embassy in Madrid reports that Enagas was less successful, winning only a 16-percent reduction in the deal signed earlier this week. The Algerians will probably offer their Belgian and Italian customers deals similar to the French accord, if agreement can be reached on amounts. Gaz de France will undoubtedly push for even further price concessions when negotiations for a three-year contract begin in June. Algiers may even decide to cut prices below those of its competitors in hopes of boosting the country's nearly 10-percent share of the European market.

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New Spanish Natural Gasfield

Spain's domestic natural gas production capacity will increase sixfold when a new field comes on stream in June, but import commitments and a limited infrastructure will probably restrict Madrid's ability to exploit it. The Gaviota field has proved reserves of 12.5 billion cubic meters (bcm) and could produce up to 1.2 bcm annually. Madrid hopes that this production level will enable it to meet 30 percent of gas consumption from domestic supplies by 1990, compared to 10 percent now. Spain's limited pipeline network, however, may restrict its ability to achieve this goal. Under the terms of contracts with Libya and Algeria, Madrid is committed to more than double its gas imports by

25X1

1992. Gas supplies already exceed pipeline capacity, and efforts to generate additional demand by expanding the pipeline system and encouraging industry to switch to gas are proceeding slowly. Madrid will probably be forced to reduce planned production from the Gaviota field until consumption picks up or import obligations are renegotiated. The latter is more likely in view of the impact of declining oil prices on Algeria's negotiating position. [redacted] 25X1

[redacted] 25X1

International Finance

[redacted] 25X1

Continuing Soviet Financial Activity

[redacted]

Moscow has arranged a $427 million, eight-year untied credit with a West German bank, bringing total long-term syndications for the year to almost $800 million. The USSR also has sold at least an estimated $1 billion worth of gold and stepped up sales of negotiable paper. At the same time, the US Embassy reports the Soviets continue to cut back large projects being negotiated with Western firms and are even canceling some planned purchases. The USSR is probably trying to take advantage of low interest rates and attractive gold prices to improve the maturity structure of its debt and to increase liquidity in the face of declining oil revenues and the weakening dollar. Moscow is unlikely to rely on sharply increased borrowing as a long-term solution but may be using its current good credit standing to buy time to develop a more coherent strategy before cutting imports further. [redacted] 25X1

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Global and Regional Developments

Funding Problems for EC Research Program

[redacted]

Community members later this year will probably reject the EC Commission's proposal to initiate a new R&D program—"The European Technology Community"—on 1 January 1987, a year ahead of schedule. Despite unanimous support at last week's Research Council meeting for shifting emphasis 25X1 from energy to industrial competitiveness, French, West German, and British delegates balked at the recommended $9 billion price tag. With yet another EC budget crisis looming, Big Three representatives want guarantees that EC research spending will yield tangible improvements in industrial competitiveness. Moreover, they have apparently decided that research priorities must be clear and that simply throwing money at the problem is not enough to close the technological gap. A West German suggestion to delay the the new program until 1988—the end of the current four-year program— received strong support and will probably be the Council's final decision later this year. Cuts in the $9 billion price tag also are probable. [redacted] 25X1

Egypt's Continued Stalemate on Debt to USSR

[redacted]

Egypt and the USSR have failed to resolve their deadlock over Cairo's estimated $2.5 billion debt for military equipment, according to the US Embassy in Moscow. Despite the lack of progress during the Egyptian Economic Minister's visit to Moscow late last month, both sides agreed to continue discussions in Cairo later this spring. Nonetheless, the Soviets are 25X1 pursuing better bilateral relations in other areas. Neither Moscow nor Cairo seems prepared to break the deadlock. Economic difficulties give Egypt little flexibility to offer concessions. Moscow probably sees concessions as having little chance at present of drawing Egypt away from its dependence on US aid, but it will continue the dialogue, partly to exploit Cairo's differences with the United States. The Soviets also may be avoiding concessions because they could lead other Third World debtors to seek similar terms. [redacted] 25X1

Grain Exporters Increase Subsidies

[redacted]

Several grain-exporting nations are raising export subsidies in response to provisions of the US Farm Bill. [redacted] the EC, determined 25X1 to maintain its share of the export market, has increased cut-rate exports to unload supplies before the new crop is available at lower prices. [redacted] 25X1 25X1 In Argentina, grain export taxes have been cut up to 30 percent, and corn is selling at $15 per ton below US prices. Buenos Aires and the other grain competitors are likely to continue aggressive price cutting to undercut US prices. Meanwhile, the world grain glut continues, with import demand down 13 percent from last year. These trends may be at issue during the proposed grain exporters' summit in Vancouver next month. [redacted] 25X1

National Developments

Developed Countries

25X1

Low Wage Hikes for Japanese Unions

The initial settlements in Japan's annual wage negotiations (*shunto*) have hit historic lows, complicating Tokyo's efforts to boost domestic demand. For example, Japanese steelworkers—the traditional pacesetters—agreed to a record low raise of 2.6 percent. Auto and electrical machinery unions also accepted low increases, with only the Honda agreement breaking 5 percent. If the *shunto* follows its usual course, other Japanese industries will settle for approximately the same gains. The US Embassy reports that some unions, representing the more prosperous industries, are trying to break with the tradition giving the metalworkers the pacesetter role in the negotiations. Private railway workers, for example, are demanding a 10.3-percent raise. Nonetheless, we doubt the final average gains will be much higher than the initial hikes.

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Dublin Provides Business With Tax Incentives

Dublin has proposed a package of tax incentives that is unlikely to do much to stimulate business and employment. The Finance Minister hopes the proposals announced this month, together with lower oil prices, will stimulate the economy and reduce unemployment, which reached 18 percent at the end of 1985. The package includes cuts in taxes on dividend income from manufacturing firms and lower capital gains taxes on assets held more than six years. To provide assistance to small firms, Dublin will establish a 30-percent capital gains tax on shares of the smaller companies market on the Irish stock exchange, a lower rate than on other capital gains. The government also announced tax incentives for firms involved in research and development.

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Less Developed Countries

Good News on Brazilian Inflation

Consumer prices in Brazil declined nearly 1.5 percent in March as a result of the bold program launched on 28 February featuring wage and price freezes, currency reform, and elimination of indexation. This was the first monthly decrease in the consumer price index in nearly three decades. Food prices—

25X1

which posted increases of over 14 percent per month from December through February—fell 5 percent last month. In a public address on Monday, President Sarney indicated that the program, known as the Tropical Plan, did not hurt economic activity and cited increases in retail sales of 10 percent, in exports of nearly 35 percent, and in industrial activity of 12 percent during March. Despite these achievements, serious obstacles lie ahead. To maintain industrial and business support, and to avoid discouraging new private investment, price adjustments will be necessary. Because the price freeze is by far the most popular aspect of the program, Brasilia will be forced to proceed cautiously, Moreover, Brazil will need to take more vigorous steps to contain expansion of the money supply and slash public spending—politically difficult measures in an important election year. 25X1

25X1

Mexicans Protest High Utility Prices

Month-long protests in Monterrey against December hikes of government-controlled prices for gas and electricity have caused the government to announce a rollback in gas prices of up to 40 percent, according to the US Embassy. The likely prospect of further and more intense protests in Mexico's third-largest city over reduced government subsidies for utilities and other basic consumer goods will probably make the de la Madrid administration even more reluctant to make spending cuts in these areas. 25X1

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Honduran-Nicaraguan Debt Talks

Honduras agreed in principle during talks in Managua last week to reschedule some $60 million in Nicaraguan trade arrearages, including unpaid electricity bills, and to take unspecified Nicaraguan commodities in partial payment. The Nicaraguans promised to catch up on back debt within a year, according to press accounts. The US Embassy in Managua reports, however, that Nicaragua's lack of foreign exchange reserves makes this highly unlikely. Tegucigalpa is not a major supplier of electricity to Nicaragua but will almost certainly limit Managua's purchases until an overall debt accord is reached. Managua probably hopes the agreement will further postpone payments to Honduras and perhaps lead to an expansion of barter trade, while Tegucigalpa probably views the accord only as a means of recovering some of the outstanding debt. 25X1

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Pakistan Decontrols Cooking Oil

In a major move to liberalize the economy—and please foreign aid donors—Islamabad decided last week to decontrol cooking oil prices, according to the US Embassy. To keep consumers happy, Pakistan had long resisted US and multilateral donor suggestions to decontrol prices, even though the unrealistically low prices meant high government subsidies, increased consumption, and higher imports. In addition to decontrolling prices, the new regulations also standardize import duties and eliminate excise taxes on cooking oil. Islamabad, however, will still influence prices—a government-owned company is the largest supplier—and can regulate production through capacity licensing. If domestic prices rise, sagging domestic oilseed production will be stimulated and expensive imports—$462 million in FY 1985 (July/June)—will fall. 25X1

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Little Change in Pertamina's Management

[redacted]

The retention of key members of the state oil monopoly's Board of Directors—contrary to widespread rumors in recent weeks of a wholesale shakeup—is likely to reassure Indonesia's foreign investors and creditors. The move is in keeping with the Soeharto regime's desire to convey a sense of continuity and stability before the 1987 general election despite a faltering domestic economy. 25X1 Most significant is the retention of Major General Ramly as President Director despite speculation that he would be moved over to the Department of Mines and Energy as Junior Minister for Oil. Ramly has performed well during his two years at the Pertamina helm and has gained the confidence and support of foreign oil companies. [redacted] 25X1

Poor Afghan Economic Performance

[redacted]

President Karmal's speech to the Revolutionary Council on 2 April gave an unusually bleak assessment of recent economic performance. While reiterating claims of great strides in economic development since the 1978 revolution, Karmal criticized a number of ministries and departments for falling short of 25X1 their goals because of "... laziness, lack of proper organization, and a lack of discipline ...." He chastized government farms, for example, for achieving only 60 percent of expected production owing to mismanagement. Damage caused by insurgents was mentioned several times. Previous official statements concerning economic activity have largely been devoted to announcing the successful completion of development goals, with only fleeting reference to disruptions caused by insurgents. By identifying laggard bureaucracies publicly, the regime is following recent practice in Moscow and probably is putting officials on notice that they will be replaced unless their performance improves. At the same time, giving prominence to disruptions caused by insurgents may be an attempt to shift the blame for shortages of goods and services. [redacted] 25X1

Communist

USSR Competing for Nuclear Power Plant Sales

[redacted]

The Soviets have tried to sell nuclear power plants to 12 countries in the past two years. [redacted] 25X1 25X1 In addition to the political leverage to be derived, the Soviets would gain prestige in beating Western competition for high-technology contracts. Moscow also would earn hard currency, replacing part of the revenue being lost on oil and gas exports. It is doubtful that the Soviets can sustain an ambitious export program without further delaying their own nuclear power plans. Moreover, many potential Third World customers prefer Western technology or will require major financial inducements. [redacted] 25X1

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East European–Soviet Trade Slowdown Last Year

Eastern Europe's trade deficit with the USSR fell by more than 40 percent, to 1.1 billion rubles in 1985, according to Soviet trade statistics. Poland was the only exception to the trend, and accounted for nearly all of the region's deficit. Trade grew at the slowest pace in more than a decade because of smaller increases in CEMA trade prices and a poor start due to winter weather. Romanian exports to the USSR stand out, rising last year by more than one-fourth. The reduced trade deficit means that Eastern Europe has nearly met Soviet demands for balanced trade, while Poland's large deficit shows Moscow's continued willingness to give Warsaw special assistance. The sharp rise in Romanian exports reflects Bucharest's desire for larger Soviet energy deliveries. The growth of Soviet–East European trade will probably continue to diminish, and most East European countries probably will soon achieve surpluses. The value of Soviet oil deliveries will fall beginning next year as lower world oil prices gradually affect CEMA prices.

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China's Foreign Exchange Holdings Revised

China's foreign exchange reserves fell by 30 percent last year—nearly twice the rate previously reported—according to revised data released recently by the IMF. The new figures substantiate speculation that in the third quarter of 1985 China began to include holdings of foreign government securities in its calculation of reserves. This revision explains why reserves appeared to increase by $1.7 billion in the third quarter despite a growing trade deficit. The new figures indicate that reserves actually dropped almost $1 billion during that quarter. The change in accounting practices brings China's methods more in line with Western practices but also may have been in response to domestic criticism of the drop in foreign exchange reserves. In the near term, China's reserve holdings probably will continue to decline from the $12 billion yearend level, possibly to $10 billion—a level Bank of China officials maintain is sufficient for the country's needs.

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Chinese Industrial Growth Slows in First Quarter

According to official statistics, China's industrial production increased at a 4.4-percent annual rate in the first quarter, down from the unusual 23-percent rate registered in the same period last year. Production of building materials was up over 10 percent, but growth rates for consumer durables fell by about half from the fast-paced clip last year. Growth of energy production also slowed, with crude oil and coal up only 2 percent and 1.3 percent, respectively. The first-quarter slowdown continues a trend of cooling industrial production caused by controls—particularly credit restraints—imposed a year ago and by energy shortages. Industrial output increased at a 10-percent annual rate in the fourth quarter last year, and Chinese officials announced at the recent National People's Congress that the target would be 8 percent in 1986.

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China's Nuclear Ministry Takes Charge of Guangdong Plant

China announced that the Ministry of Nuclear Industry (MNI) will take over responsibility from the Ministry of Water Resources and Electric Power (MWREP) for the proposed nuclear project at Guangdong. MWREP had overseen the project through negotiations with the French and British for reactors and generators, respectively, that led to letters of intent signed last month. Foreign exchange and budget constraints have forced Beijing to emphasize the development of domestic nuclear technology—an MNI prototype nuclear plant is being built near Shanghai—instead of the expensive plant imports MWREP favors. MNI's takeover of the Guangdong plant will consolidate China's reduced nuclear program under one ministry but might cause delays in negotiations. MNI's enhanced role may also hold promise for the United States for at least small-scale nuclear cooperation and sales—MNI's plant design is based on US technology. MNI officials in the past have been more responsive to cooperation with the United States than have their MWREP counterparts.

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China Holds First Technology Export Fair

China's first trade fair for technology exports, held in Shenzhen 10-20 April, provides an unusual opportunity for foreigners to view advanced Chinese products and signaled Beijing's determination to markedly expand its technology sales. The fair showcased 1,700 items in areas such as nuclear energy, electronics, aviation, astronautics, and defense, many of which were regarded as confidential until recently, according to the Chinese press. Satellite launching technology and civilian applications of nuclear technology were the star attractions, but foreign observers considered many of the exhibits—which included herbal medicines and garments—far from advanced. To encourage potential customers, Chinese officials promised attendees legal protection and preferential treatment for technology export contracts, while some exporters offered prices lower than foreign competitors and insurance against economic losses.

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China To Withdraw Foreign Exchange Certificates

China plans to withdraw Foreign Exchange Certificates (FECs) from circulation, although the move still requires "long preparations." In circulation since 1980, FECs are a form of semiconvertible currency issued to foreign tourists and businessmen for use in hotels and hard currency "friendship stores." Their purpose is to limit the economic activities of foreigners in China and to deny Chinese access to imported consumer goods and the special services available to foreigners. The FECs quickly became both a symbol of privileges granted to foreigners and a medium for black-market currency trading. Beijing may further devalue the yuan when withdrawing the FECs to slow currency speculation but will continue to limit domestic access to foreign exchange to control imports. Withdrawal of the FECs may make some joint ventures more dependent on Beijing to provide them with foreign exchange to purchase imported materials. Black-market currency trading will probably continue to flourish—one estimate has 20 to 25 percent of Hong Kong's currency circulating in southern China.

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Next 1 Page(s) In Document Denied